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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

National Intelligence Council

DDI #1035-82
8 February 1982

MEMORANDUM FOR: Robert Cornell
Deputy Assistant Secretary for
Trade & Investment Policy
Department of the Treasury

VIA: Chairman, National Intelligence Council

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: Soviet Hard Currency Situation

1. Over the past year the Soviet Union has experienced a sharp erosion in its hard currency position. This weakening is primarily due to a combination of increased imports from the West--especially grain--and soft Western markets for Soviet crude oil and other primary product exports. The current situation represents a turnaround from the strong position the USSR enjoyed during the past several years when increased revenues from energy and raw material exports to the West allowed a substantial buildup of hard currency reserves as well as a steady growth of imports from the West. [redacted] 25X1

2. This is not to say that the USSR is on the brink of disaster. The USSR is still in a fundamentally sound financial position vis-a-vis the West. Its hard currency debt service ratio is expected to amount to only 15 percent in 1981, which reflects a still large borrowing potential. Current foreign hard currency assets total about $7 billion or roughly 3 months worth current annual hard currency imports. [redacted] 25X1 [redacted] 25X1 [redacted] Its credit rating, moreover, remains good despite concerns 25X1 of Western bankers over debt repayment problems in Poland and in Romania. The hard currency bind does mean that Moscow will not be able to maintain a continued growth of Western imports unless it turns to massive borrowing from the West in amounts that would push its debt service ratio up sharply. Even a maintenance of current import levels will require a sharp increase in borrowing. (See Table 1) [redacted] 25X1

3. The Soviet Union handled the 1981 erosion in its current account position by a variety of financing methods. Moscow drew down hard currency assets held in Western banks [redacted] stepped up gold sales 25X1 [redacted] and increased its borrowing in the West by a like 25X1

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amount (see table 2). The USSR also benefited from increased arms sales--up $1.7 billion on the strength of orders from previous years. 25X1

4. The USSR's hard currency situation is continuing to deteriorate and financing requirements could increase by several billion dollars this year. Continued soft demand for Soviet exports in world markets--especially in Western Europe--suggest some slippage will occur in the export earnings account. The critical factor will be whether oil prices in Western Europe continue to decline. On the import side, we expect the Soviet Union's agricultural bill to increase by about $1 billion as the value of purchases more than offsets softening in world food prices. According to numerous reports the USSR is cutting imports in other areas. Even so, they will have to reduce the value of imports paid for in hard currency by roughly 10 percent to offset the effects of expected Western price increases. Taking these factors into account, the Soviet hard currency trade balance could deteriorate by $1-2 billion in 1982.* The USSR probably will also have to cover other, unspecified foreign exchange expenditures.**

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* If the Yamal gas pipeline project is implemented, the Soviets import bill for 1982 would climb by about another $2 billion. The 1982 Soviet hard currency financing requirement, however, would only increase by about $300 million as most of the imports would be covered by Western credits. Yamal, therefore, is of little significance for Soviet financing needs over the next few years.

** A major problem in assessing Moscow's hard currency financing requirements is that in recent years the recorded capital inflow has greatly exceeded the deficit on recorded trade and specified current account transactions. This discrepancy which enters the balance of payments as a residual "errors and omissions" entry in recent years has taken the form of a net foreign exchange outflow, with large year-to-year variations. It averaged $2.7 billion during 1977-80, and apparently jumped to over $4 billion in 1981. We cannot account for such large discrepancies. Some plausible Soviet hard currency expenditures which we cannot estimate include:

- o Hard currency payments to Eastern European countries for above plan deliveries or bilateral clearing accounts;
- o Hard currency payments to developing countries which cannot be separated from soft loans; and
- o Hard currency support for Poland.

5. Moscow has a number of options available again this year to meet its prospective financing requirements. Gold sales could be increased even above last year's [redacted] strategies adopted by other major suppliers. As for credits, Moscow already has assurance for about $1.7 billion in guaranteed credits for major (non-Yamal) projects underway. In addition, we believe the Soviets could easily tap the Western commercial lenders for $500 million more than last year, particularly if credits are tied to Western exports. If Western lenders balk at incresing their exposure to the USSR, Moscow still would have the option of drawing upon the $7 billion worth of hard currency deposits in Western banks.

6. If however Moscow steps up hard currency aid to Poland this year, its financing requirement could be larger than implied by our projections. The Soviets at a minimum might be persuaded to provide $2.3 billion to pay for food and other essential imports Warsaw needs to buy from the West. In this circumstance, financing hard currency needs would be more difficult. Moscow would have to dip into gold stocks, cut imports even further, or borrow more. Even so, the Soviets probably would try to minimize their exposure rather than resume on the massive scale characteristic of the mid-1970s. (See table 3)

7. We anticipate that many of the factors that have contributed to the weakening of the Soviet's hard currency position will continue to keep Moscow in a hard currency bind for the foreseeable future. Only an unlikely combination of events--a tightening of Western oil markets, a series of good Soviet grain harvests and a strong pick-up in Western economies--would offer relief from the current hard currency bind. If the Soviet Union fails to maintain a substantial volume of crude oil exports to the West--which is highly probable over the coming years--the hard currency bind could turn into a hard currency crunch of major magnitude.

8. The only large new source of hard currency earnings on the horizon is the Yamal pipeline, which should yield about $5 billion a year in net hard currency earnings by the late 1980's, but will involve a net drain of foreign exchange in the next few years. Prospects for exports of raw materials, such as wood, are poor because of high Soviet production and transport costs. Exports of manufactures should increase, but there are no signs that Moscow will be able to overcome its major deficiencies in quality, flexibility, and marketing. Soviet arms sales are already very large--nearly $5 billion a year--and it is difficult to see where large further increases in the market for Soviet arms will be coming from. Although gold sales can be stepped up, Moscow must be careful not to spoil the market. On balance, Soviet export products other than oil and gas are likely to show little or no growth in the 1980's. (See Table 5)

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9. But the growth in earnings from gas exports will probably be more than offset by a decline in earnings from oil exports. Since 1978 Soviet oil exports for hard currency have fallen about 10 percent. Oil production has leveled off and a decline is in prospect for the 1980's, although there is a great deal of uncertainty as to when it will begin. Under these conditions Moscow's total oil exports are almost certain to fall, which means that exports to hard currency countries must also fall unless Moscow diverts to these countries oil supplies now going to Eastern Europe--a possible but quite risky remedy. By the late 1980's Soviet hard currency oil exports are likely to be nil or very small. (See Table 6) 25X1

10. The prospects for stagnation or decline in Soviet foreign hard currency earnings, during the 1980's indicate that Moscow will be unable to increase the volume of its hard currency imports unless the West provides more credit and Moscow accepts a larger hard currency debt. Attempts to increase hard currency imports at even a moderate rate (for example, 3% per year) would almost certainly lead to an unacceptably large indebtedness and debt service requirements by the end of the decade. Even by mid-decade the debt service ratio would at least double. (See Table 7) 25X1

11. Moscow is unlikely to push hard currency imports to the limit of what Western creditors will finance, but rather will slowly cut back on imports of the least essential products. If continued cuts are necessary, however, Moscow will face difficult decisions in the longer term because the bulk of its hard currency imports are important to high priority Soviet goals for food production, energy development, and raising the level of technology and productivity of Soviet industry. Even in the near term, the USSR's worsening hard currency position is likely to reduce Moscow's ability and willingness to give Poland or other East European countries financial support. 25X1

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Table 1

Million US $
Except as Noted

USSR: Hard Currency Debt to the West

	1971	1975	1976	1977	1978	1979	1980 [a]	Projected 1981
Commercial debt	400	6,900	9,700	9,800	9,500	10,500	10,000	10,800
Government-backed debt	1,400	3,600	5,200	5,900	7,000	7,800	8,200	8,500
Gross debt	1,800	10,500	14,900	15,700	16,500	18,300	18,200	19,300
Assets with Western banks	1,200	3,100	4,700	4,500	6,000	8,800	8,600	7,000
Net debt	600	7,400	10,200	11,200	10,500	9,500	9,600	12,300
Debt service	300	1,800	2,300	3,100	4,100	4,000	4,900	5,000
Debt-service ratio *(percent)* [b]	10	18	17	19	21	15	16	15

[a] Preliminary.
[b] Debt service as a percentage of earnings from merchandise exports, sales of arms and gold, interest, invisibles, and transfers.

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Table 2

USSR: Hard Currency Balance of Payments

(Billion US $)

	1981 (Estimated)	1982 (Projected)
Trade Balance	-6.0	-8.0
Exports, f.o.b.	23.9	23.0
oil	11.5	10.5
gas	3.4	3.5
other	9.0	9.0
Imports, f.o.b.	-29.9	-39.0
agricultural	-12.0	-13.0
non-agricultural	-17.9	-18.0
Arms transfers & net invisibles	5.2	4.8
Current account balance*	-0.8	-3.1
Credits drawn, net	1.1	1.4
commercial	0.8	1.1
government backed or guaranteed	0.3	0.3
Net decline in Soviet assets in Western banks	1.6	1.6
Gold sales	2.7	3.5
Errors and omissions**	-4.6	-3.4

* Excludes transactions connected with the Yamal pipeline and sales of gold, which are treated as a balancing financing transaction.

** This item is a residual balancing item used in balance of payments analysis to reconcile trade as reported by the USSR and other current account transactions (which must be estimated) with Western source data on financial flows.

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Table 3

USSR: Hard Currency Balance of Payments

Million US $

	1960	1965	1970	1975	1976	1977	1978	1979	1980	1981[a]
Trade Balance	−250	−186	−500	−6,422	−5,595	−3,300	−3,794	−2,036	−2,455	- 6,100
Exports, f.o.b.	768	1,374	2,201	7,835	9,721	11,345	13,157	19,549	23,792	23,900
Imports, f.o.b.	1,018	1,560	2,701	14,257	15,316	14,645	16,951	21,585	26,247	30,000
Gold sales	200	550	0	725	1,369	1,618	2,522	1,267	1,700	2,700
Net interest	−2	−17	−83	−568	−716	−846	−881	−799	−710	- 1,100
Other invisibles and hard currency trade not included elsewhere[b]	−66	−46	605	1,551	2,011	3,300	3,523	5,140	4,900	6,000
Current account balance	**−118**	**301**	**22**	**−4,714**	**−2,931**	**772**	**1,370**	**4,472**	**2,535**	1,500
Direct investment abroad[c]	0	0	0	−3	−31	0	0	0	0	0
Borrowing from abroad[d]	88	41	291	5,402	4,694	1,777	1,002	860	526	NA
Lending to other countries[e]	0	0	−25	295	−1,711	140	−1,582	−2,926	0	NA
Capital account balance	**88**	**41**	**266**	**5,694**	**2,952**	**1,917**	**−580**	**2,066**	**526**	NA
Errors and omissions[f]	30	−342	−288	−980	−21	−2,689	−790	−2,406	−3,061	- 4,600

[a] Estimated.

[b] Including estimated receipts from arms sales, official transfers, and net receipts from tourism and transportation.

[c] Estimated investment in Soviet banking operations in the West.

[d] Soviet drawings on Western credits and East European investment in construction of the Orenburg pipeline. Excludes borrowings by the International Investment Bank and International Bank for Economic Cooperation, which borrow on behalf of CEMA countries. The extent to which the USSR has borrowed (if at all) from these CEMA banks is unknown.

[e] Net change in Soviet assets held with Western commercial banks and in trade credits extended to finance Soviet exports.

[f] Including intra-CEMA hard currency trade and other hard currency payments.

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Table 5 Million 1970 US $

USSR: Hard Currency Commodity Exports Other Than Oil and Gas

	1970	1975	1976	1977	1978	1979	1980
Total	**1,801**	**2,281**	**2,430**	**2,313**	**2,994**	**3,160**	**2,821**
Coal and coke	93	86	89	88	70	65	58
Machinery and equipment	140	277	319	314	514	566	507
Ferrous metals	129	182	174	123	142	141	134
Wood and wood products	365	361	449	427	405	380	328
Chemicals	67	159	129	143	196	324	403
Agricultural products	205	264	227	256	175	138	112
Diamonds	175	282	284	291	376	380	376
Other	627	670	759	671	1,116	1,166	903

Source: Estimates based on Soviet foreign trade data.

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Table 6

USSR: Hard Currency Earnings

(Billion 1981 US$)

		High Oil*		Low Oil *	
	1981	1985	1990	1985	1990
Merchandise Exports	23.9	22.5	21.7	14.0	21.7
Oil	11.5	9.5	0.0	1.1	0.0
Natural Gas	3.4	4.0	12.7	4.0	12.7
Other	9.0	9.0	9.0	9.0	9.0
Receipts from Gold	2.0	4.2	4.2	4.2	4.2
Receipts from Arms	5.0	5.0	5.0	5.0	5.0
Invisibles & transfers	1.0	1.0	1.0	1.0	1.0
Total Receipts	31.9	32.9	31.9	24.2	31.9

* High oil assumes hard currency sales plateau at 900,000 b/d through 1985 then drop to zero in 1990; low oil assumes oil exports largely disappear by 1985.

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Table 7

USSR: Projected Borrowing and Import Requirements*

(Billion 1981 US $)

		High Oil		Low Oil	
Import growth of 3 percent per year	1981	1985	1990	1985	1990
Imports	30.0	33.7	39.1	33.7	39.1
Total Debt	19.3	38.4	98.0	59.8	163.1
Debt Service Ratio	15%	25%	68%	47%	116.%
Borrowing limited to 1980 level ($2.5 billion)					
Imports	30.0	29.3	25.5	21.9	25.5
(as a % of 1981 imports)		(87)	(65)	(65)	(65)
Total Debt	19.3	24.9	23.3	24.9	23.3
Debt Service Ratio	15%	18%	22%	24%	22%

* Assuming hard currency earnings for high oil and low oil scenarios cited Table 6.